

José De Gregorio: Chile's latest Monetary Policy Report

Presentation by Mr José De Gregorio, Governor of the Central Bank of Chile, of the Monetary Policy Report before the Finance Commission of the Honorable Senate of the Republic, Santiago de Chile, 4 April 2011.

The Monetary Policy Report of March 2011 can be found at <http://www.bcentral.cl>.

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Introduction

Mr. President of the Senate's Finance Commission, senator Eduardo Frei, senators. I am grateful for the Commission's invitation to the Board of the Central Bank of Chile to share with you our vision of recent macroeconomic developments, their prospects and implications on monetary policy, as detailed in our *Monetary Policy Report* of March 2011.

The data at hand on the last few months show that our country continues to walk a path of sustained economic recovery. The year 2010 closed with a y-o-y growth rate of 5.2 percent, with very strong consumption and investment. To a large extent, the devastation inflicted on our economy by the world recession of 2008–2009 and the earthquake and tsunami of 27 February 2010 has been left behind. Employment is growing strongly and trend inflation has returned to above zero annual variation rates.

The strong impulse of macroeconomic policies has been at the center of these results, and the recovery of the Chilean economy attests to the efficacy of our economic policy framework. However, although the challenges posed by the aforesaid events have been largely overcome, today we face new ones. As we noted in the presentations we made before this Commission and the Senate in full last December, the world economy is undergoing a process of recovery in two speeds, generating significant foreign exchange tensions.

In early January the Board announced a program of foreign-currency purchases to alleviate these tensions and increase Chile's international reserves to match those of other emerging economies. Such program involves the purchase of 12 billion US dollars over a period that ends in December this year. Three months into the process, the Bank has bought a little over 3 billion dollars. The peso/dollar parity is now around 3 percent above the level that prevailed before the purchase announcement, fluctuating in the range of 465 to 500 pesos per dollar. The overall trends that have determined an appreciation of the currencies of most emerging economies – including the Chilean peso – are still present. We believe that without the intervention the peso would have appreciated even more.

The resolution of growth imbalances around the world will probably take some time, but sooner or later the differences between emerging and developed economies will narrow, mitigating pressures on our currency. Beyond these fluctuations, the gains in competitiveness that our country needs in order to remain on the path to development will be achieved not with actions that artificially increase the level of the nominal exchange rate, but rather with structural reforms that will improve productivity and, therefore, the competitive stance of our exports.

The many differences in the speed of the economic recovery in the world has combined with foreign exchange tensions and, in the past few months, increased inflationary pressures at the global level. Food prices, responding to the stronger demand of emerging economies and to worsened supply-side conditions, have skyrocketed, rising even faster than between early 2007 and mid-2008. Add to this the sustained increase in the oil price since mid-2010, which intensified last February because of the political unrest in the Middle East and Northern Africa.

Under these circumstances, today monetary policy faces an important challenge. Like after the global financial debacle of 2008, when it was highly flexible in responding to the confidence crisis around the world, now it must again be flexible in withdrawing the monetary stimulus, creating the conditions for sustainable growth and acting preventively to avoid a resurgence of inflation. Since last December, the Board has raised the monetary policy interest rate (MPR) by 75 basis points to 4 percent in the meeting of last March. In the scenario we consider the most likely, we will continue to remove the monetary stimulus, at a pace that will depend on unfolding macroeconomic conditions, but which will be principally oriented to achieving the inflation target. Now let me describe the factors that underlie the most likely scenario and the main risks it faces.

Macroeconomic scenario

In the last few months, y-o-y CPI inflation, in line with projections in December's Report, has hovered around the target, with an annual variation of 2.7 percent at February. Core indicators have returned to positive, yet still low (figure 1). Nonetheless, as I said, even if actual inflation continues to be aligned with the target and our previous forecasts, the latest developments have increased our concern for inflation, as they have in other economies. In the emerging world, growth has proceeded as expected, within an environment where foreign exchange tensions remain and commodity prices continue on the rise, especially for oil and foodstuffs (figure 2). This latter phenomenon has shaped a scenario of higher inflation and, accordingly, higher expectations.

Actual inflation has already begun rising in developed economies. In the U.S. it went from 1.1 percent annually in September 2010 to 2.1 percent in February this year, and in the Eurozone it went from 1.9 percent to 2.4 percent over the same period. Worth noting is the behavior of inflation in the U.K., where it has been above the 2-percent target since December 2009 and now stands at somewhat more than 4 percent. Partly as a result of the wide output gaps that persist in these economies, core inflation remains in low levels (figure 3). Emerging economies have seen inflation's velocity of expansion begin rising, especially for core inflation in Asia. The higher international prices of foodstuffs have a strong impact on inflation in these economies, considering that they weigh more in their CPI baskets.

Inflation forecasts for 2011 have been raised everywhere. Worth noting is the case of emerging Asia, where by mid-2010 the market consensus expected inflation to average 3.8 percent annually this year, and revised it upward to 4.8 percent last March (figure 4). The baseline scenario assumes that during this year the external inflation relevant to Chile will exceed December's forecast.

In this scenario, the central banks of several economies have either started or continued their monetary policy normalization processes, implying that inflation might be temporarily above their targets, which coincides with the market consensus expectations. Some of them have continued applying alternative measures to tone down increases in liquidity and credit, such as China, India, Brazil and other countries in the region. In some developed economies, although monetary policy has remained very expansionary – with unconventional measures and record-low interest rates – policy makers have explicitly exposed their concerns about future inflation and a few have even considered the option of beginning their cycle of normalization sooner. Thus, in the U.S. and Europe, market expectations regarding the timing of the process's kick-off have changed (figure 5).

Hence, the outlook for world economic growth is somewhat brighter than it was last December. Actual output data in developed economies, especially in the U.S., have exceeded expectations and market consensus projections have been revised upwards. For 2011, the world growth forecast assumed in this Report's baseline scenario is three decimal points higher than in December. Financial tensions relating to the situation in some European

economies are still in place. The catastrophe in Japan has sounded an alarm, but so far its effects are believed to be limited primarily to the Japanese economy (table 1).

In Chile, output gaps have behaved as predicted, leading to a normalization of the inflation trend. As I said before, in 2010 GDP grew 5.2 percent, so we believe output gaps are closed (figure 6). The strength of domestic demand, particularly for consumption, has been at the center of this phenomenon. Labor gaps have narrowed, with a fast increase in employment and higher wages.

This performance of the economy reflects to a great extent the impulse of monetary policy to domestic expenditure and the world's economic recovery. For 2011, the Board foresees that GDP growth will be in the range of 5.5 to 6.5 percent, the same it forecast in December (table 2). This scenario is coherent with output gaps remaining closed over the entire projection horizon.

The recent dynamism of the economy will moderate in line with the reduced impulse from macroeconomic policies. As for monetary policy, our projections use as a working assumption that the MPR will follow a path that is comparable with the one that can be inferred from the various expectations surveys (figure 7). For the case of fiscal policy, the working assumption is that fiscal expenditure will increase this year less than will output, consistently with the recent announcement of the government on the matter, to subsequently converge to a structural deficit of 1 percent of GDP until the end of the current Administration's term.

In the baseline scenario, the cyclical situation of the Chilean economy plus the withdrawal of the macroeconomic stimulus will result in y-o-y CPIX1 inflation moving from its present level of around 0.5 percent to a little over 3 percent in the early part of 2012 (figure 8). It is expected to then oscillate around the target until the end of the projection horizon, that is, the first quarter of 2013. Headline inflation, meanwhile, will surpass the upper bound of the target range, largely due to the effects of higher prices of oil and oil derivatives. The baseline scenario assumes that the oil price will average somewhat more than 100 dollars per WTI barrel in the two-year period 2011–2012. Accordingly, annual CPI inflation will stand above 4 percent for the entire second half of this year and into 2012. For December 2011, it is forecast at 4.3 percent, which compares with 3.3 percent assumed in December. Inflation projections for the latter part of this year have been revised upward in many economies around the world, even before the oil shock intensified (figure 9). As for the inflation forecast used in this Report's baseline scenario, a large part of the change responds to the direct impact of the fuel price increase. In the case of non-perishable foodstuffs, actual inflation data for the last few months show an increase that reflects December's projections. The baseline scenario assumes that it will continue to rise at annual rates in the order of 4 to 5 percent during 2011 (figure 10).

Thus, the Board foresees that annual CPI variation will return to the tolerance range during the second quarter of 2012 and will stay at 3 percent until the end of the year. This forecast assumes that the propagation of price increases in foodstuffs and oil will follow historic experiences. It also assumes that the economy will grow at a pace consistent with its capacity, limiting the propagation of these shocks to other prices and to labor cost pressures.

Private inflation expectations are similar to those described in the baseline scenario. March's Economic Expectations Survey (EES) shows an inflation rate at December of this year of 4.4 percent. The Financial Operators Survey for the second half of March shows inflation one year ahead at 4.4 percent. These two figures are slightly higher than they were in December 2010. For the medium term, expectations also rise and the EES of March foresees inflation two years ahead at 3.2 percent (figure 11). With respect to end-of 2010, breakeven inflation figures derived from financial asset prices have also increased for all the different terms. Likewise, business and consumer confidence surveys show increased concerns about inflation.

As usual, there are various risks that could shape a different macroeconomic scenario. On this occasion, the Board believes the risk balance for both inflation and output is biased upward.

The main risk to inflation has to do with the size, persistence and propagation of the shock to commodity prices, especially oil. Internationally, as I said, the baseline scenario assumes that the oil price will be high and fairly stable. However, it may happen that the political tensions in some oil-exporting countries continue or intensify, resulting in a steeper upward trend. The global effects of such a setting are clearly inflationary in the immediate future, while further down the line its combined effects on world demand and interest rates may moderate world economic activity (table 3). In the case of foodstuff prices, current aggregate indexes are above their peak of 2007–2008, although the composition of products showing the bigger increases differs. In any case, the velocity of these hikes has been greater than that of the last episode (figure 12). Both futures prices and analysts' projections assume that the prices of these products will not increase further but will rather tend to normalize. Still, it cannot be ruled out that if supply-side problems in the agricultural sector persist within a context of strong growth in emerging economies, pressures on the prices of foodstuffs may be intensified.

Regarding the internal propagation of the shock to commodity prices, food prices have increased less locally than internationally, indicating a compression of margins in the industry. Overall, this compression reverses the expansion they posted in the second half of 2008 and throughout 2009, after the fall in external prices (figure 13). However, it cannot be ruled out that, if international prices continue to rise, further effects on domestic inflation may be observed.

As for oil, due to conditions inherent in this market, pass-through to consumer prices has been instantaneous. Facing additional shocks, the stabilization system in place could help smooth short-term fluctuations in fuel prices. Nonetheless, it is not its objective, in a medium-term horizon, to isolate local price movements from external ones. In addition, the effects might be amplified if the availability of hydroelectric energy diminishes increasing the dependence on thermal energy generation based on oil derivatives. Recall that in 2007–2008 energy prices rose considerably because of an electric production mix that was more intensive in thermal generation at a time that the oil price was hitting record highs. Today, the marginal cost of electric generation is 25 percent below its peak of 2008 (figure 14).

Another difference between the current situation and the episode of 2007–2008 has been the evolution of the exchange rate. Whereas then the exchange rate depreciated continually, amplifying the effect of external price increases, in the past few months the peso-dollar parity has shown large swings, and is now, as of the statistical closing of this Report, at around CLP480 per dollar. After the Bank's announcement of the reserve accumulation program in early January, the peso depreciated from some CLP465 per dollar to nearly CLP500 per dollar. After that there was an appreciation trend that took it back to pre-intervention levels; however, the effects of this measure have combined with external developments, in particular the sustained weakness of the dollar at the global level and the copper price increasing to all-time highs in nominal terms (figure 15). Thus, since its peak of late 2008, the appreciation of the peso against the U.S. dollar has not differed much from that of the currencies of commodity-exporting countries or other economies that have intervened or applied administrative measures in their forex markets (figure 16).

The real exchange rate (RER) followed the trend of the multilateral parity, which has depreciated since December. Considering the level of the nominal exchange rate and parities prevailing at the statistical closing of this Report, in March the RER posted figures in line with its long-term fundamentals (figure 17). The baseline scenario of this Report uses as a working assumption that the RER will stay near its recent levels.

Regarding the propagation of the relative price shocks to the overall economy – or second-round effects – one important factor is significantly related with the sensitivity of inflation

expectations to the short-term behavior and the flexibility of real wages. It is possible that, if the economy sustains its dynamism beyond its installed capacity, it may foster a greater propagation of these shocks to other prices and to labor costs, heightening its inflationary effects. As I said before, the baseline scenario assumes that gaps will remain closed over the projection horizon, but the possibility remains that output and demand grow above forecasts, thus exceeding the normal use of the economy's productive capacity and exacerbating inflationary pressures. Conversely, increased prices of fuels and other products affect the consumers' disposable income and, thereby, can become a factor moderating expenditures in other goods and services.

In the international scenario, financial tensions remain in some European countries and global imbalances are far from being resolved. There are also doubts regarding how tight output gaps are and how strong are inflationary pressures in some emerging economies, especially in Asia, and how will policy makers and investors respond to the signs of higher inflation that are appearing. Considering the experience of 2007–2008, this might trigger a monetary policy reaction that could cause a more pronounced slowdown in the demand of emerging economies, with important consequences on world growth and commodity prices. On the other hand, it is also possible that the different paces of recovery between emerging and developed economies and the exchange rate tensions in place result in a delay in the withdrawal of the monetary stimulus, causing an immediate increase in global inflation and calling for more aggressive monetary policy responses later on.

Conclusions

Today monetary policy conduct is facing an important challenge. Headline inflation is near the target and trend inflation is back to above-zero figures, albeit still substantially below 3 percent. However, inflationary pressures have increased globally raising inflation forecasts, spreading concerns about future inflation in the different economies, including our own. The recovery process of the Chilean economy has consolidated and output gaps are closed.

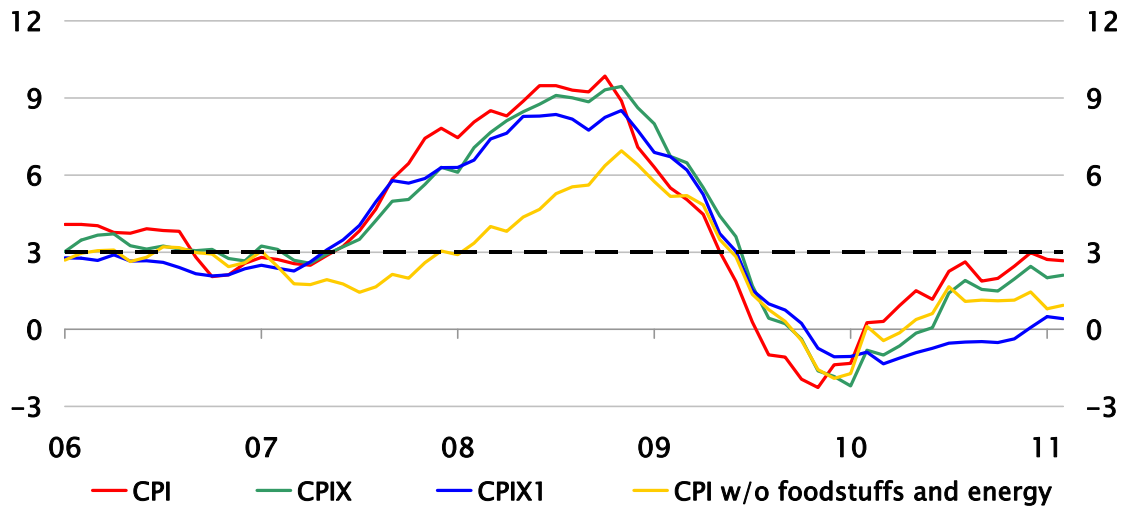
As I said a while ago, the increases we have seen in international prices of foodstuffs and oil will result in total inflation surpassing the upper bound of the tolerance range during some quarters. Our main task today is to ensure that the convergence of trend inflation to the target occurs with as few setbacks as possible. Monetary policy conduct will aim at the inflationary trend remaining in levels consistent with the tolerance range, so that towards the end of the projection horizon headline inflation stands around 3 percent.

There are important risks, though. The recent experience with international price shocks has shown that preoccupation per se will not solve their inflationary consequences. It is absolutely necessary to take action every time these shocks give signs that they may propagate from specific sectors to the rest of the prices in the economy. Preventing such propagation is the primary task of monetary policy. In this Report's baseline scenario, the foreseen trajectory of monetary policy meets this objective.

In any case, as it has done in the past, the Board will adopt any necessary measures to deal with events altering the macroeconomic scenario and the inflationary outlook. As our country's economic history has shown, and reminded us unequivocally just a few years back, inflation is an evil that hits especially hard those who have the least resources. The main contribution that the Central Bank can make to the country's development is to keep inflation low and stable, paving the way for sustainable growth. Making today the necessary changes to monetary policy will avert more severe adjustments in the future that would certainly increase the associated social costs. Accordingly, the Board will continue to conduct monetary policy so that annual projected inflation into a two-year horizon stands at 3 percent.

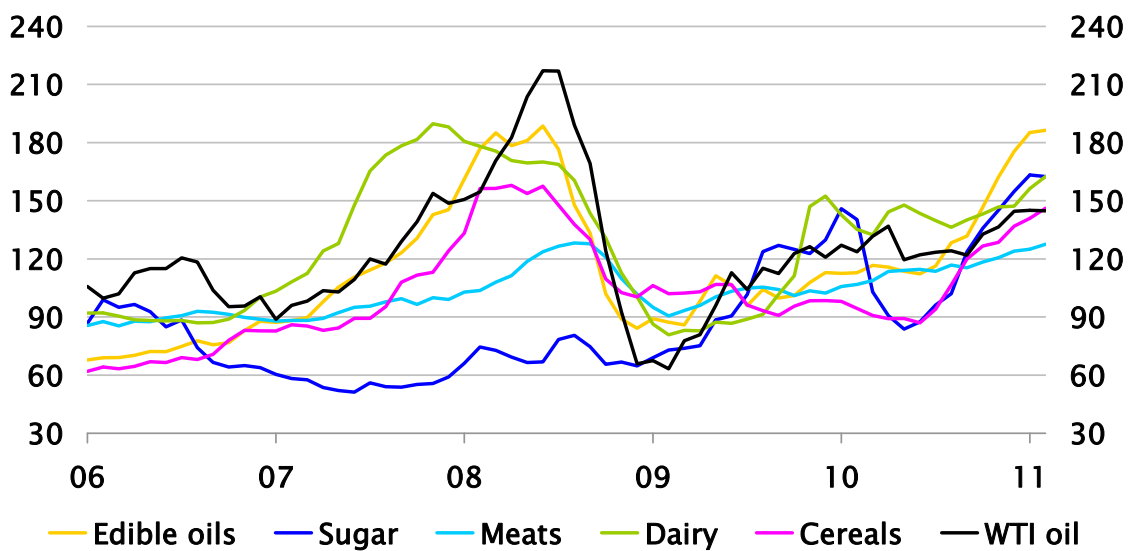
Thank you.

Figure 1
Inflation indicators
 (annual change, percent)



Sources: Central Bank of Chile and National Statistics Institute (INE).

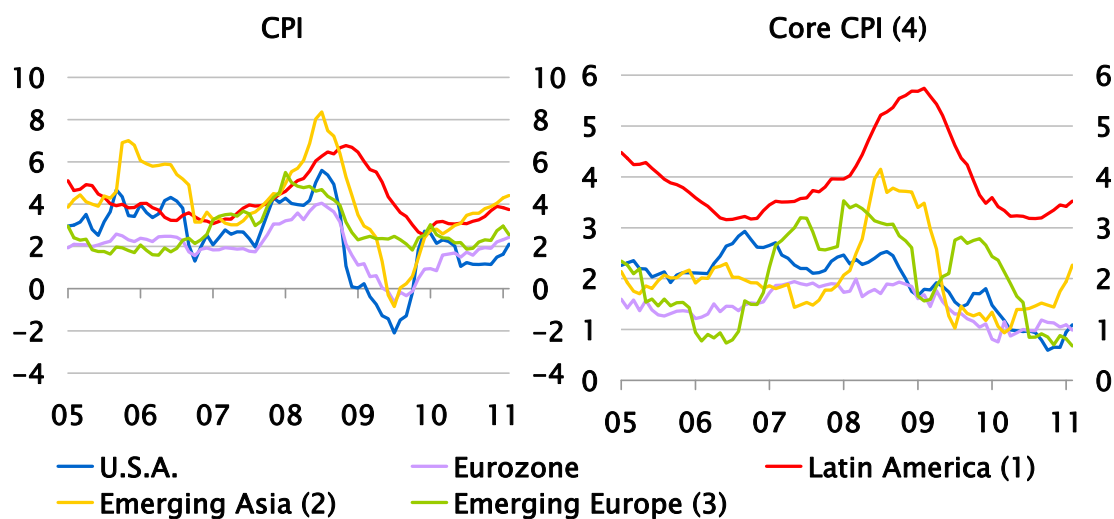
Figure 2
Commodity prices (*)
 (index, 2009=100)



(*) Except for WTI oil, FAO indexes are used.

Source: Bloomberg.

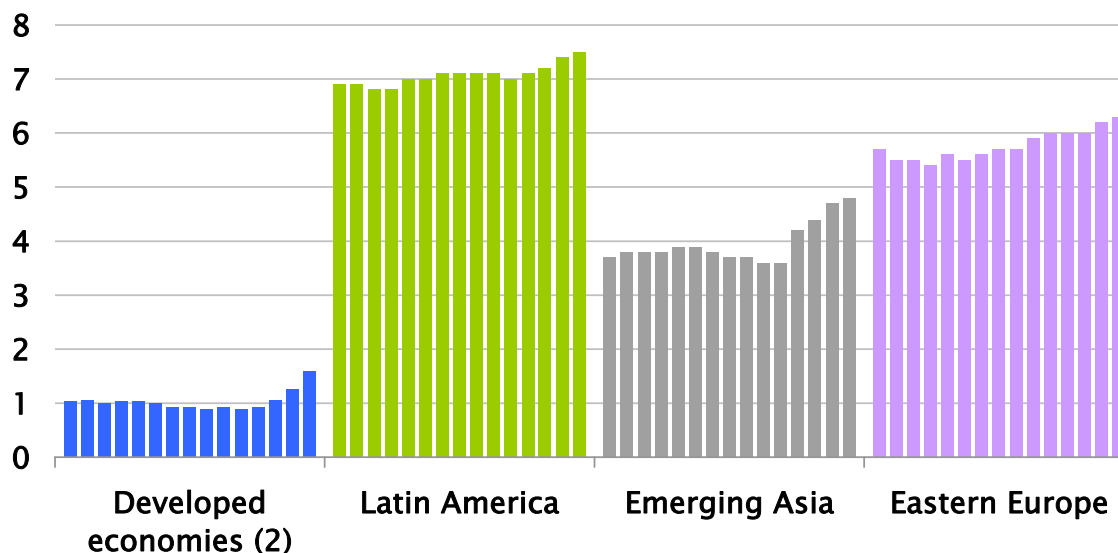
Figure 3
Inflation
 (annual change, percent)



(1) CPI and Core CPI include: Brazil, Colombia, Mexico and Peru. (2) CPI includes China, Indonesia, Malaysia, South Korea and Thailand. Core CPI includes South Korea and Thailand. (3) CPI includes Czech Rep., Hungary, Poland and Russia. Core CPI excludes Russia. (4) Uses definition of each country.

Sources: Bloomberg, CEIC Data and statistics institutes of respective countries.

Figure 4
Inflation expectations for 2011 (1)
 (annual change, percent)

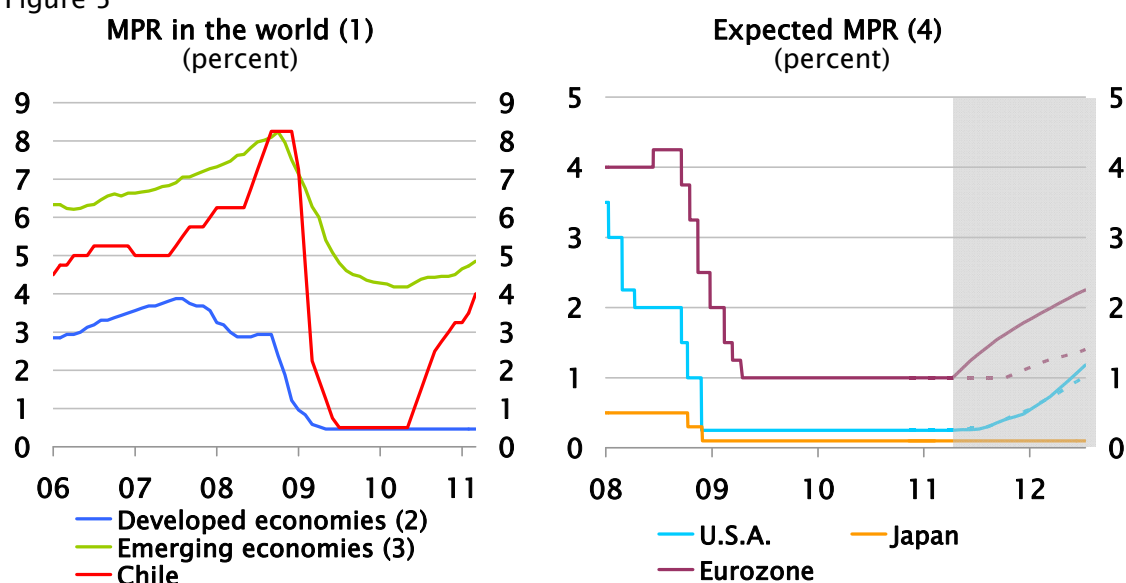


(1) Average inflation of the year, with the exception of Latin America, which uses inflation at December 2011.

(2) Geometric average for the U.S., the Eurozone and Japan.

Source: Consensus Forecasts.

Figure 5



(1) Simple average of reference rates for each group of countries. (2) Includes the U.S., Japan, the U.K. and the Eurozone. (3) Includes Brazil, Colombia, China, the Czech Rep., Hungary, Mexico, Peru, Poland, South Africa and South Korea. (4) Gray area indicates trajectory implicit in futures contracts. Dotted line shows market forecast at the statistical cutoff of December's Monetary Policy Report.

Sources: Central bank of respective country and Bloomberg.

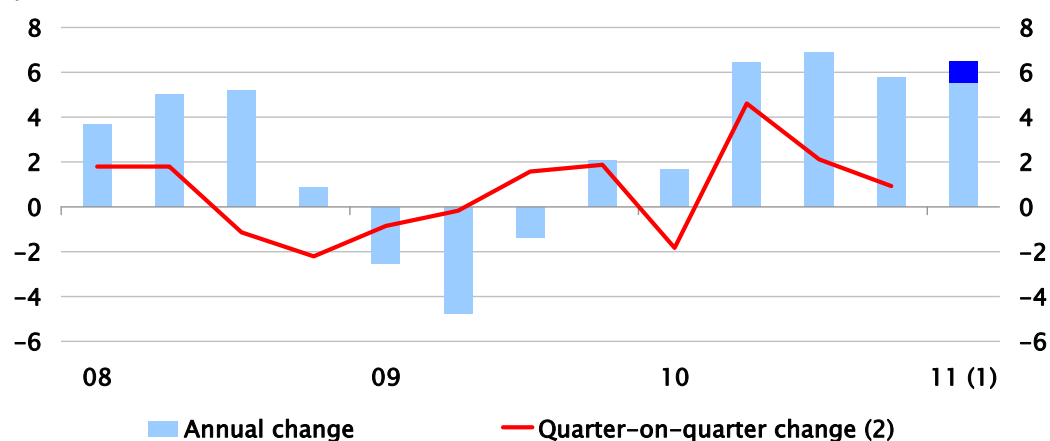
Table 1
World growth
(annual change, percent)

| | Average 90-99 | Average 00-08 | 2009 | 2010 (e) | 2011 (f) | 2012 (f) |
|--------------------------------|---------------|---------------|------|----------|----------|----------|
| World at PPP | 3.0 | 4.0 | -0.6 | 5.0 | 4.1 | 4.4 |
| World at market exchange rates | 2.8 | 3.0 | -2.0 | 3.6 | 3.0 | 3.7 |
| United States | 3.2 | 2.3 | -2.6 | 2.9 | 3.0 | 3.2 |
| Eurozone | 2.2 | 2.0 | -4.1 | 1.7 | 1.3 | 1.5 |
| Japan | 1.5 | 1.4 | -6.3 | 3.9 | 0.8 | 2.3 |
| China | 10.0 | 10.4 | 9.2 | 10.3 | 8.9 | 8.7 |
| Rest of Asia | 5.6 | 4.9 | 0.1 | 7.6 | 4.5 | 5.0 |
| Latin America (excl. Chile) | 2.7 | 3.7 | -2.0 | 6.4 | 4.2 | 4.2 |
| Commodity exporters | 2.7 | 2.9 | -1.0 | 2.8 | 2.6 | 3.0 |
| Trading partners | 3.1 | 3.6 | -0.3 | 5.9 | 4.4 | 4.6 |

(e) Estimate. (f) Forecast.

Sources: Central Bank of Chile based on a sample of investment banks, Consensus Forecasts, the International Monetary Fund and statistics institutes of the respective country.

Figure 6
GDP growth
 (percent)



(1) Dark blue shows growth range for GDP forecast for 2011 in Monetary Policy Report of March 2011. (2) Seasonally-adjusted series.

Source: Central Bank of Chile.

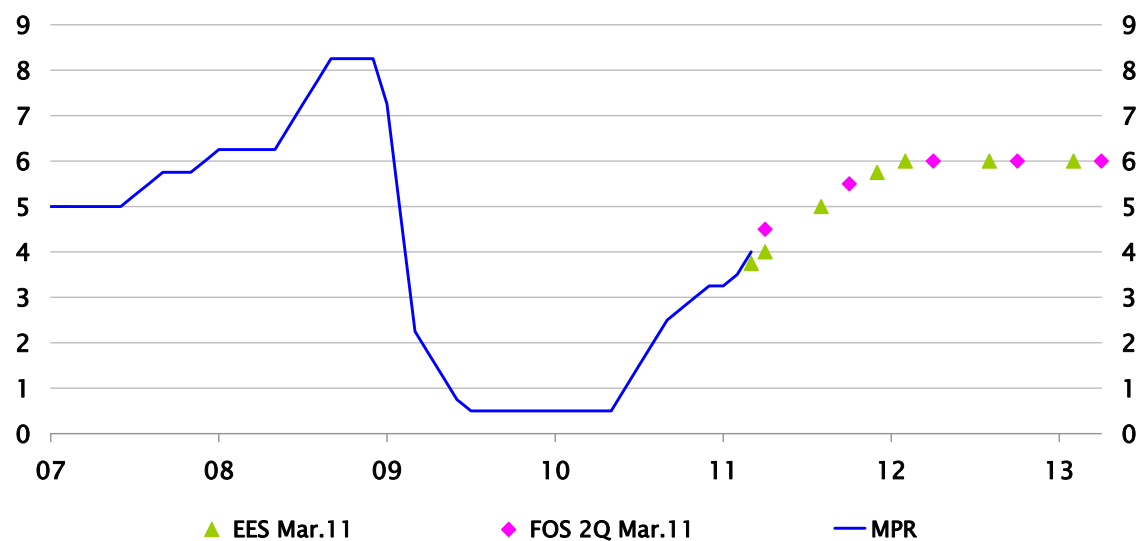
Table 2
Economic growth
 (annual change, percent)

| | 2009 | 2010 | 2011 (f) |
|---|-------|------|----------|
| GDP | -1.7 | 5.2 | 5.5-6.5 |
| Domestic demand | -5.9 | 16.4 | 7.6 |
| Domestic demand ((w/o inventory change) | -2.9 | 11.5 | 8.7 |
| Gross fixed capital formation | -15.9 | 18.8 | 13.9 |
| Total consumption | 1.9 | 9.3 | 7.0 |
| Goods and services exports | -6.4 | 1.9 | 6.8 |
| Goods and services imports | -14.6 | 29.5 | 9.6 |
| Current account (% GDP) | 1.6 | 1.9 | 1.2 |

(f) Forecast.

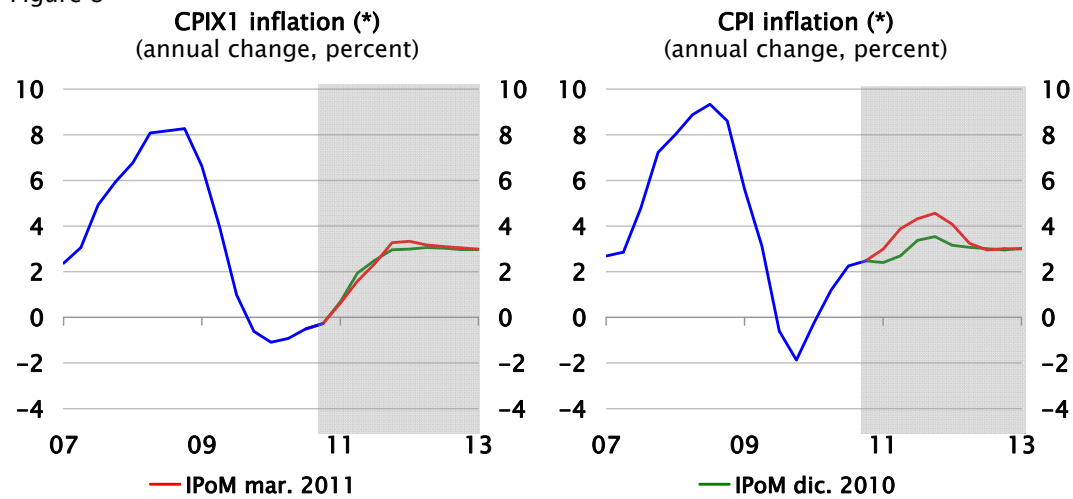
Source: Central Bank of Chile.

Figure 7
MPR and expectations
 (percent)



Source: Central Bank of Chile.

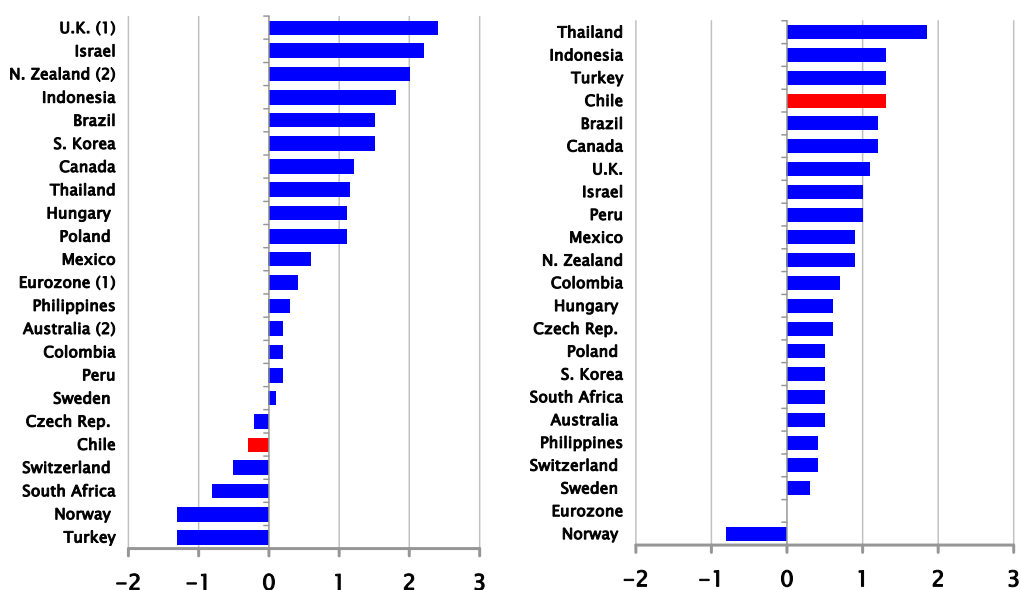
Figure 8



(*) Gray area, as from first quarter of 2011, indicates forecast.

Sources: Central Bank of Chile and National Statistics Institute (INE).

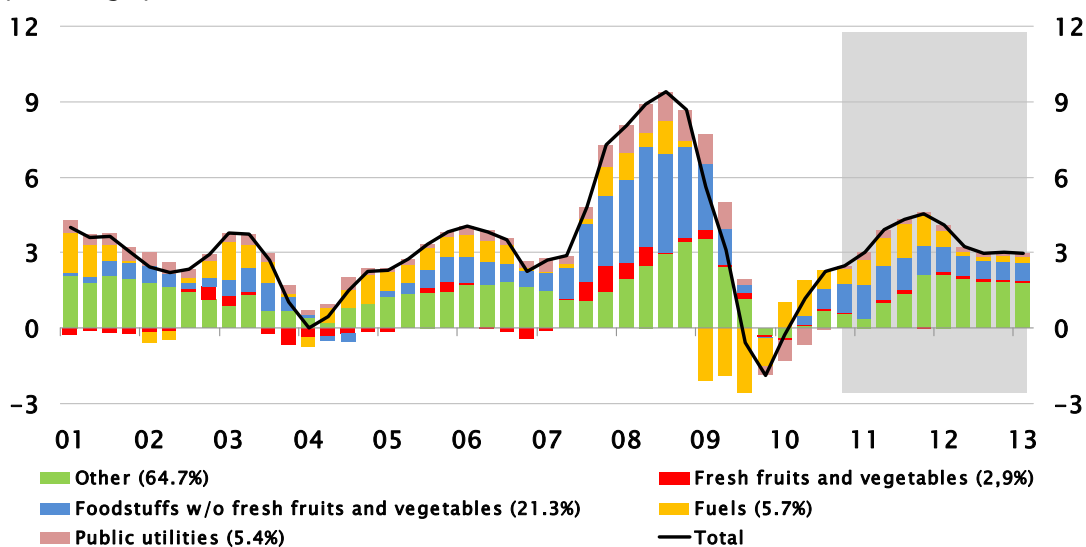
Figure 9
Inflation deviations from target
 (percentage points)



(1) Harmonized series. (2) Spot inflation at fourth quarter 2010. (3) Inflation projected by March's Consensus Forecasts. For Chile, baseline projection in March 2011's Monetary Policy Report.

Sources: Bloomberg and Consensus Forecasts.

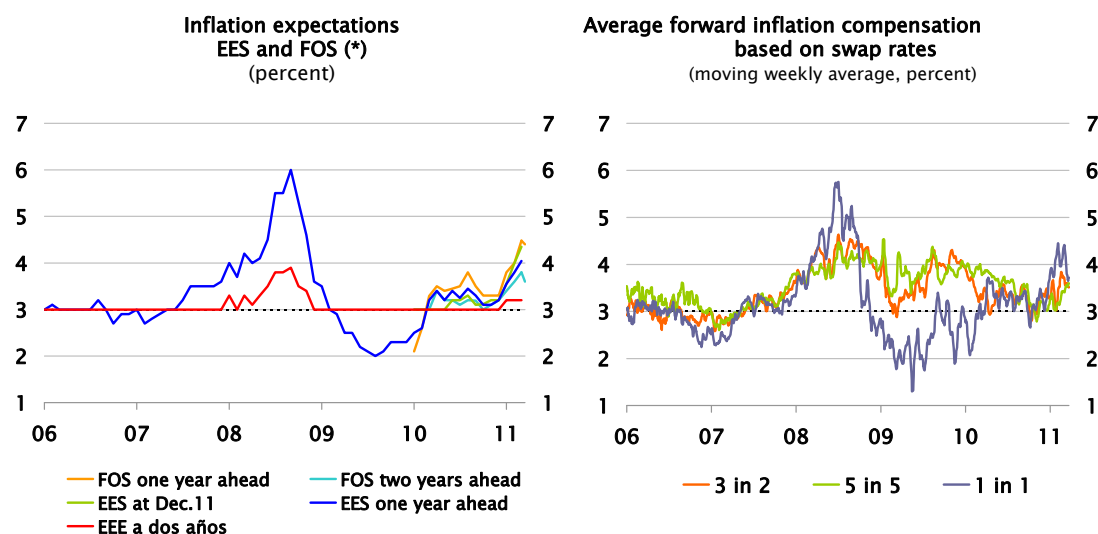
Figure 10
Incidences on annual CPI inflation (1) (2)
 (percentage points)



(1) Gray area, as from first quarter 2011, indicates breakdown of inflation forecast in baseline scenario. (2) In parentheses, shares in CPI basket.

Sources: Central Bank of Chile and National Statistics Institute (INE).

Figure 11



(*) The FOS considers the survey of the first half of the month. Only for March, the second half is also considered.

Source: Central Bank of Chile.

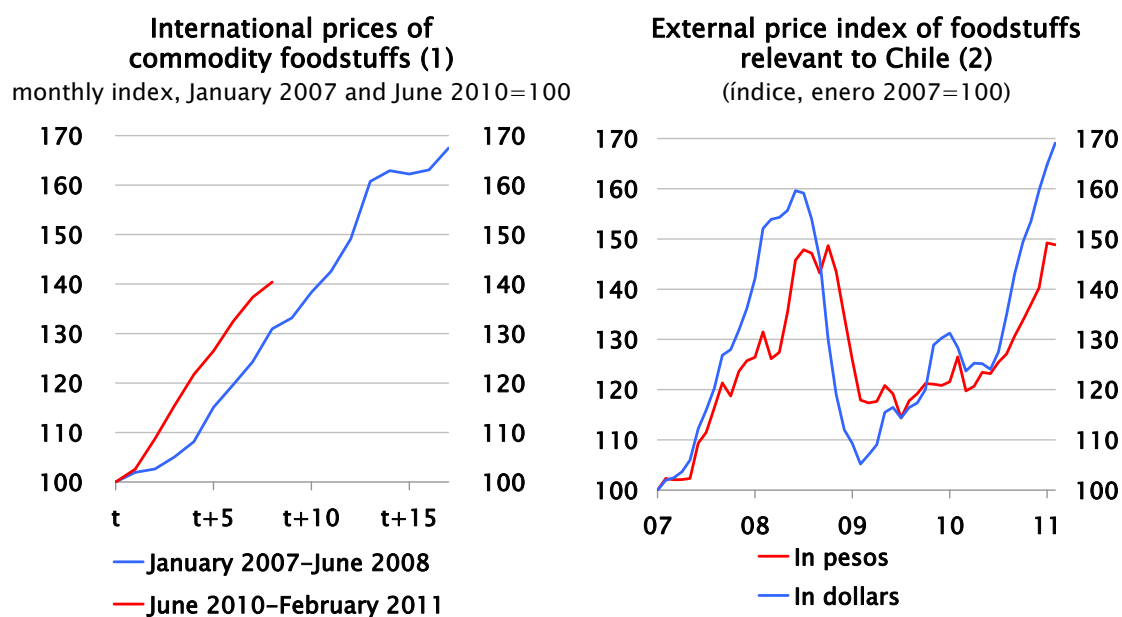
Table 3
Impact on GDP and inflation of a US\$10 increase in the oil price (*)
 (percentage points)

| | FMI | | OCDE | | Consenso de mercado | |
|------------------|------|-----------|------|-----------|---------------------|-----------|
| | PIB | Inflación | PIB | Inflación | PIB | Inflación |
| United States | -0.6 | 0.6 | -0.3 | 0.5 | -0.35 | 0.5 |
| Eurozone | -0.4 | 0.2 | -0.3 | 0.5 | -0.5 | 0.4 |
| Japan | -0.2 | - | -0.4 | 0.3 | -0.3 | 0.3 |
| Emerging | -0.2 | - | - | - | -0.2 | - |
| Asia -exc. Japan | -0.8 | 0.7 | - | - | -0.8 | 0.7 |
| China | -0.8 | - | - | - | -0.27 | 0.46 |
| Latin America | -0.2 | - | - | - | - | - |
| World | -0.4 | - | - | - | -0.4 | - |

(*) For comparison purposes, the shocks of the respective studies have been adjusted to equal magnitudes.

Sources: Central Bank of Chile, Deutsche Bank, International Monetary Fund and OECD.

Figure 12

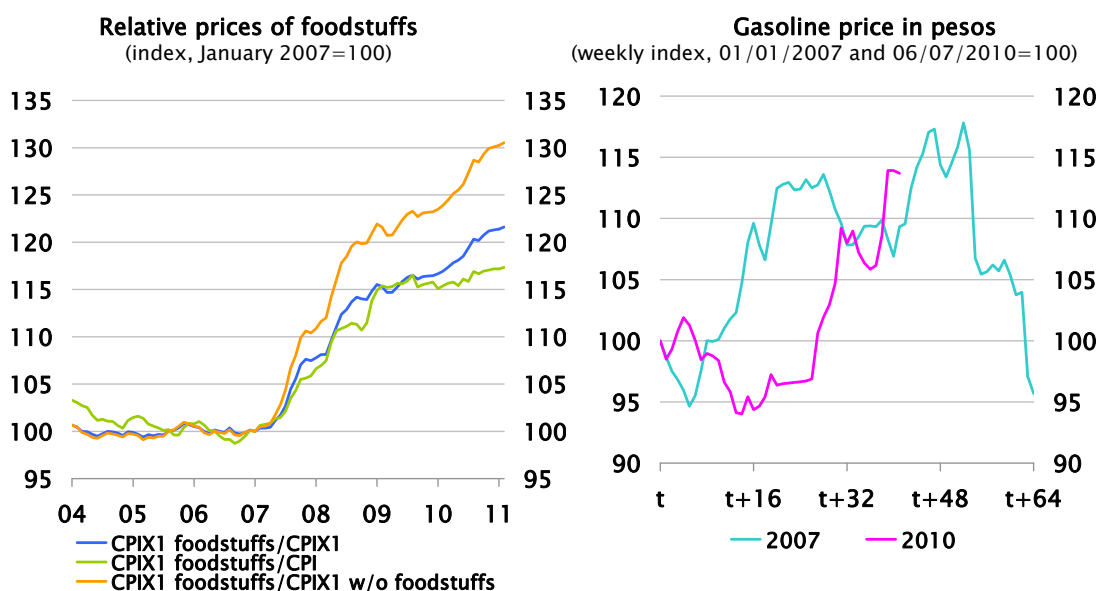


(1) Based on FAO index that uses average prices of monthly transactions in the main markets.

(2) Based on weights of international prices of the various foodstuffs according to shares in CPI basket.

Sources: Central Bank of Chile, Bloomberg, FAO and National Statistics Institute (INE).

Figure 13



Sources: Central Bank of Chile, ENAP and National Statistics Institute (INE).

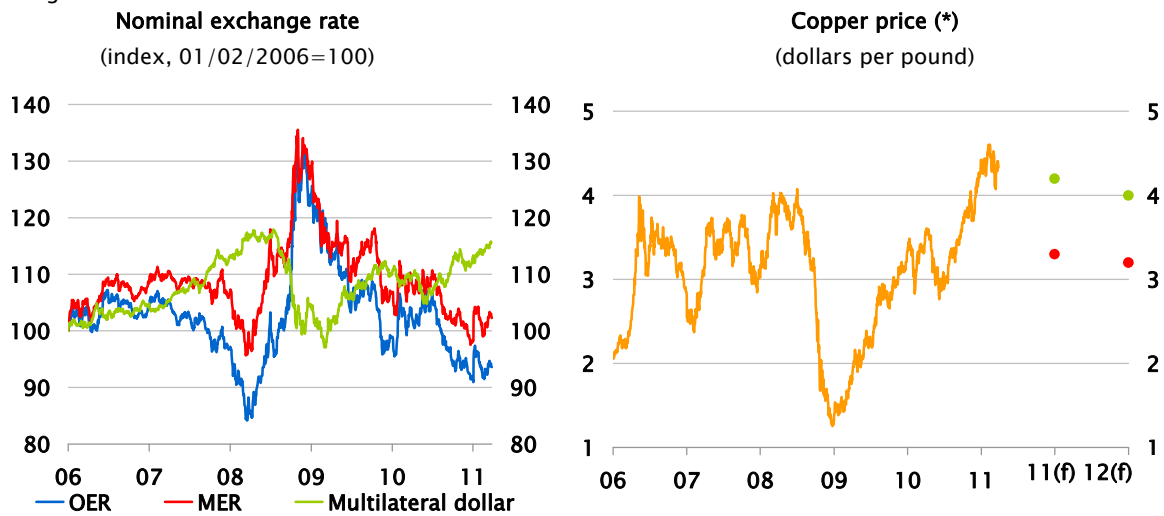
Figure 14
Marginal cost of electric generation (*)
 (dollars per MWh)



(*) Alto Jahuel subsystem.

Source: Center for the Economic Charge Delivery (CEDEC) of the Central Interconnected System.

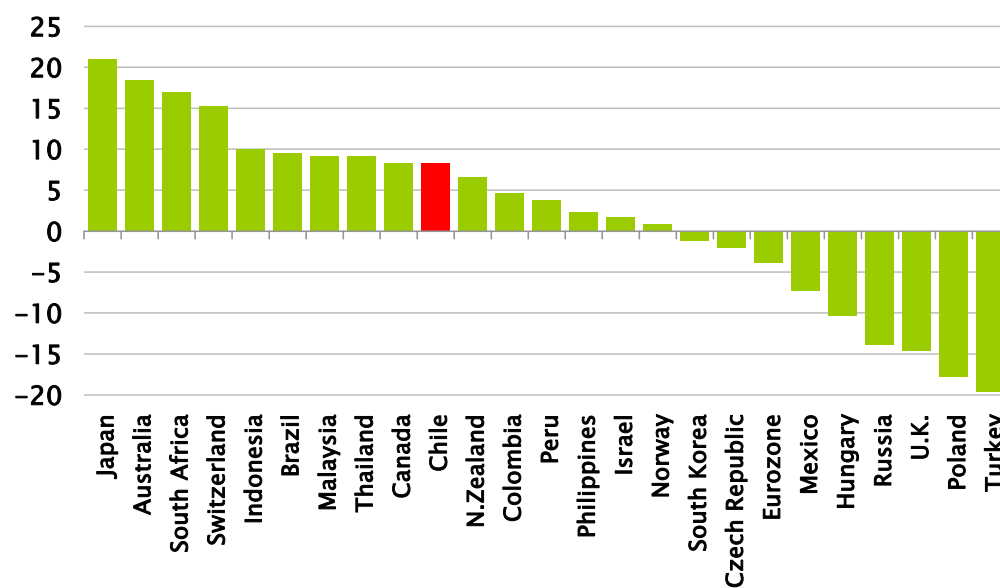
Figure 15



(*) Red dots indicate average copper price forecast for 2011 and 2012 in December 2010's Monetary Policy Report; green dots indicate the same in March 2011's Report.

Sources: Central Bank of Chile and Bloomberg.

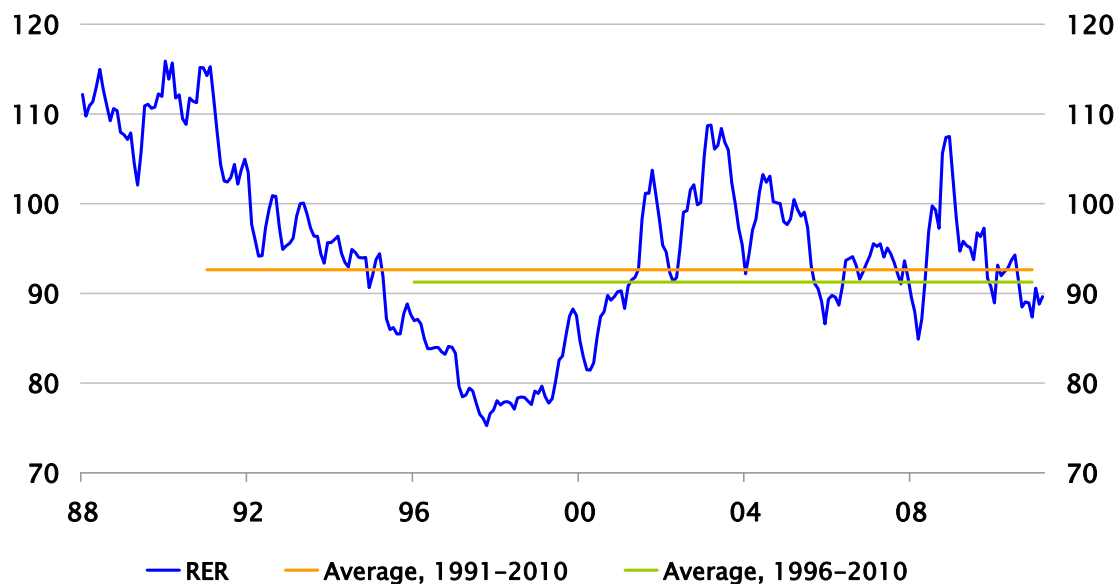
Figure 16
Change in nominal exchange rate with respect to 2008 average (*)
 (percent)



(*) Above zero value indicates an appreciation of the local currency against the U.S. dollar.

Source: Bloomberg.

Figure 17
Real exchange rate (*)
 (index, 1986=100)



(*) Information at 28 March 2011.

Source: Central Bank of Chile.